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Capital Flows Put Pressure on the Yen

In just one month's time, overheated demand for the dollar wiped out the yen's hard-won gains of the past few months. The yen, along with all other major currencies, weakened against the dollar throughout July, hitting a ten-month low. Japanese exchange-market experts are predicting that the yen could fall as low as Y250 to the dollar before long. Analysts point to wide real interest rate differentials between the United States and Japan as well as the liberalization of Japanese financial markets as key factors in the shift of the yen-dollar exchange rate.

The Japanese currency began July by falling almost one yen against the dollar over the June 30-July 1 weekend, from Y237.50 to Y238.65 (median rate) as traded on the Tokyo interbank spot market. By July 6, the yen had fallen to Y240.80 on rumors of higher U.S. interest rates and jitters over the Iran-Iraq war, and it continued to drop for the rest of the month, tumbling to Y242.10 by the second week of July, Y243.05 in the third week, and Y244.50 by July 27. For the month as a whole, the yen declined 3.4 percent, ending up at

at Y241.40=$1.00 on August 6. The yen's decline has not been as steep as that of the European currencies, yet many expect it to remain in the Y240 to Y250 range for some time. As Mr. Gyoten pointed out to the prime minister, the yen-dollar exchange rate will not change course overnight.

Jon Choy

Finance Ministry Adopts 7 Percent Defense Budget Ceiling

The Ministry of Finance (MOF) proposed on July 31 an increase in Japanese defense spending of no more than 7 percent for fiscal year 1985 (April 1985-March 1986). The official budget ceiling, negotiated over the past two months by MOF, the Japan Defense Agency (JDA) and supporters of defense spending, constitutes the first step in formulating the government's budget for the coming fiscal year.

Defense was again a standout in otherwise austere budget proposals. Overall, MOF recommended increasing the general account budget by no more than 0.86 percent, compared with an increase of 0.5 percent for the current fiscal year. Last year at this time, MOF settled on a defense ceiling of 6.88 percent, with actual defense allocations increasing by 6.55 percent. The ministry had proposed a 5 percent increase for FY 1984, with JDA pressing for 7 percent. The fiscal 1985 budget compromise was worked out by Finance Minister Noboru Takeshita and JDA chief Yuko Kurihara. The finance minister had proposed a spending hike of no more than 3.5 percent, while Mr. Kurihara sought an 8 percent increase.

Proposed and Actual Defense Spending
Fiscal Year 1984
(March 1984-April 1985)

(in billions of yen)

Allocation:	Proposed	Change from FY 83	Actual	Change from FY 83
Ground Self-Defense Forces (GSDF)	1,069.728	4.1%	1,077.539	4.9%
Maritime Self-Defense Forces (MSDF)	711.896	8.8	705.984	7.9
Air Self-Defense Forces (ASDF)	765.409	9.4	758.721	8.5
Internal Bureaus	9.955	3.7	9.980	4.0
Joint Staff Council	1.804	88.8	1.696	77.6
National Defense Academy	.717	-3.7	.719	-3.6
National Defense College	9.646	6.9	9.673	7.2
Defense Medical College	11.363	1.1	11.395	1.4
Technical Research and Development Institute	44.295	14.7	43.758	13.3
Central Procurement Office	4.376	-1.7	4.409	-1.0
Defense Facility Administration Agency	314.511	5.3	310.647	4.0
National Defense Council			.124	0.0
Total	2,943.7	6.9	2,934.645	6.55

The budget ceilings are similar to the first budget resolution approved annually by Congress. They are designed to set target spending levels for the coming fiscal year, without necessarily representing final figures. There is still room for negotiation among government agencies, but the figures released by the Finance Ministry generally do not deviate significantly from the final totals approved by the cabinet.

An increase of 7 percent in Japan's defense budget would amount to Y205.5 billion ($840 million), bringing total spending to just over Y3.1 trillion ($12.8 billion). The spending hike, at a time when government policymakers are determined to reduce budget deficits by controlling expenditures, may represent the minimum annual spending increase for defense for the coming years. Japanese leaders, particularly Prime Minister Nakasone, appear committed to fulfilling domestic defense plans and shouldering a larger burden in the region.. Although many U.S. analysts contend that annual spending increases exceeding 10 percent are needed to achieve those goals, the figure adopted by MOF does not represent a step backward for defense in Japan.

The prime minister is likely to come under fire during the coming months for pressing forward on defense while maintaining constant spending levels in other areas, particularly in accounts which would help stimulate the domestic economy. Mr. Nakasone's rivals for the Liberal Democratic Party (LDP) presidency already have called for stimulative budgets for the coming years and can be expected to make this a major issue as the fall election approaches. This may have convinced the JDA director to accept a spending hike more or less in line with recent increases.

Another factor influencing the budget figure was the country's "one percent policy," which limits total defense spending to one percent of the country's gross national product. With the Japanese economy growing more rapidly than anticipated, defense spending has remained just below the one percent level so far, and it is expected to stay at 0.99 percent of GNP through the remainder of FY 1984. Given current estimates for economic growth in the year starting in April 1985, the hikes should not push total defense expenditures above that threshold. While the debate may appear unimportant to outside observers, the prime minister has vowed to make every effort to maintain the one percent ceiling. Exceeding the level at this point could affect his credibility and damage his chances for reelection.

Once the cabinet confirms the FY 85 budget, it will be presented to the Diet for approval. The most significant phase in the budget process is the establishment of budget ceilings. Final figures generally deviate only slightly from the initial proposals. Fiscal 1984 defense appropriations, for example, varied only slightly from the proposals made in 1983.

The proposed increases may not satisfy American critics of Japan's defense efforts, who seek even higher spending levels and a greater role for the country in the region, but the hikes are considerably larger than those expected from many NATO countries, as they have been for the past several years. While Japan may be able to afford to spend more on defense, the increases probably reflect the current political limit until such a time as policymakers are satisfied that budget austerity may be discontinued and public opinion accepts an enlarged role for the Self-Defense Forces in Japan.

Michael Chinworth

small- and medium-sized firms. The American variant would be funded through stock issues instead of through loans from government and private banks as in the case of JAROL. Like JAROL, the U.S. corporation would offer engineering and technical advice to firms interested in installing robots and provide low-interest loans subsidized by the Commerce Department's Office of Industrial Technology ($20 million is authorized annually for FY 1984 to FY 1987). Also like JAROL, the idea is being criticized as expensive and ineffective. The bill is in the House Banking Committee's Economic Stabilization Subcommittee with no action scheduled.

In the House Science and Technology Committee is H.R. 4047, the Robotics and Automated Manufacturing Systems Research and Education Act, which would provide funds to the National Science Foundation for a group of programs promoting robotics. Tentatively funded at $37.25 million in FY 1983, $59.25 million in FY 1984 and $72.25 million in FY 1985 through FY 1990, the integrated package includes research activities, establishment of research centers to facilitate robotics technology transfers, limited R&D partnerships with private firms, and education and training for private companies.

A final bill, H.R. 4048, would add 10 percentage points to the investment tax credit for expenditures on robots and computer-controlled machinery. The tax impact of the bill has not been determined, nor has its impact on the use of manufacturing robots. The bill is presently in the Tax Subcommittee of the House Ways and Means Committee with no action planned.

These bills underscore the U.S. government's commitment to fostering research and development vital to continued economic growth. They also highlight, however, the debate over the best method to realize this goal. The administration is clearly in favor of a free-market approach -- it has refused to spend the majority of the $285 million Congress authorized in 1980 for high technology research. Some congressmen, on the other hand, feel that more support must be offered, not by making the decisions for the private sector, but by making it easier for the private sector to realize its decisions. These moves appear to echo past and present Japanese initiatives. Whether the U.S. proposals represent improvements or simply copies of those ideas is yet to be determined.

Jon Choy

Bilateral Trade Deficit Likely to Top $30 Billion in 1984

The explosive growth of the U.S. economy and the upward march of the dollar's value are wreaking havoc with this country's merchandise trade account. In 1983 lackluster business conditions abroad and steady economic expansion at home teamed up with the strong dollar to produce a record-breaking overall U.S. trade deficit of $57.5 billion. With the American economy booming in 1984's first half and the dollar gaining more ground against most major foreign currencies, this full-year record had almost been shattered by midyear. A pickup in business activity overseas did reverse a two-year slide in exports, pulling them up 8.1 percent to $108.7 billion, but imports jumped 31.7 percent to $160.1 billion on a Customs value basis. The result: a whopping six-month U.S. trade deficit of $51.4 billion.

U.S. Exports to Japan

(in millions of dollars, f.a.s. value basis)

	January-June 1983	January-June 1984	Percent Change
Total Exports	$10,040.5	$11,584.7	15.4%
Industrial Supplies	4,174.9	4,478.3	7.3
Bituminous Coal	526.1	500.1	-4.9
Petroleum Products	321.9	291.9	-9.3
Natural Gas	128.2	124.0	-3.3
Nuclear Fuels	136.9	83.4	-39.1
Logs and Lumber	449.4	451.9	0.6
Paper Base Stocks	232.6	266.7	14.7
Paper and Paper Products	149.5	154.5	3.3
Organic Chemicals	324.5	360.4	11.1
Inorganic Chemicals	283.6	298.0	5.1
Plastics and Synthetic Resin Compounds	150.2	178.6	18.9
Fertilizers and Insecticides	128.3	139.5	8.7
Steel Scrap	101.2	136.5	34.9
Nonferrous Ores and Scrap	148.4	180.1	21.4
Nonferrous Metals	188.1	217.0	15.4
Textiles	48.0	55.7	16.0
Raw Cotton	235.3	358.6	52.4
Hides and Skins	113.2	166.2	46.8
Leaf Tobacco	69.5	40.0	-42.4
Food and Feed	2,429.5	2,982.3	22.8
Corn	730.0	1,107.7	51.7
Sorghum	18.4	109.9	497.3
Soybeans	553.7	639.7	15.5
Wheat	273.4	243.1	-11.1
Fruits and Vegetables	232.2	245.3	5.6
Meat and Meat Products	301.9	301.1	-0.3
Fish and Fish Products	143.0	136.9	-4.3
Capital Goods	2,317.5	2,774.4	19.7
Nonelectric Machinery	1,331.4	1,671.2	25.5
Data Processing Equipment	414.8	519.2	25.2
Measuring, Testing and Control Instruments	188.5	214.1	13.6
Laboratory Testing and Control Instruments	42.7	45.3	6.1
Scientific, Professional and Medical Equipment	110.4	125.3	13.5
Power Generating Equipment (excl. aircraft and automotive engines)	42.0	214.6	411.0
Oil and Gas Field Equipment	57.0	27.4	-51.9
Metalworking Equipment	55.5	47.0	-15.3
Service Industry Equipment	59.2	54.5	-7.9
Electric Machinery	313.5	439.5	40.2
Generators and Transformers	29.5	55.3	87.5
Broadcast and Communications Equipment	138.7	220.4	58.9
Telephonic and Other Electric Equipment	145.3	163.9	12.8

Transportation Equipment	672.6	663.7	-1.3
Civilian Aircraft	380.9	255.4	-32.9
Civilian Aircraft Engines and Parts	178.9	239.5	33.9
Automotive Parts	62.1	87.9	41.5
Consumer Goods	686.9	721.8	5.1
Pharmaceuticals	267.9	270.5	1.0
Toys and Sporting Goods	61.9	48.6	-21.5
Cigarettes	32.9	49.0	48.9

U.S. Imports from Japan

(in millions of dollars, Customs value basis)

	January-June 1983	January-June 1984	Percent Change
Total Imports	$19,112.9	$27,037.5	41.5%
Automotive Products	7,167.2	9,019.4	25.8
Passenger Cars	5,317.0	6,017.9	13.2
Assembled Trucks	935.4	1,333.7	42.6
Automotive Parts	908.3	1,629.5	79.4
Capital Goods	5,404.6	8,899.8	64.7
Nonelectric Machinery	3,598.2	6,016.4	67.2
Business Machines	1,672.7	3,064.5	83.2
Metalworking Machinery	294.1	394.2	34.0
Agricultural Machinery	101.8	176.2	73.1
Specialized Industrial Machinery	308.5	639.9	107.4
Scientific, Professional and Medical Equipment	142.3	225.6	58.5
Electric Machinery	1,685.1	2,739.4	62.6
Transportation Equipment	121.3	144.0	18.7
Consumer Goods	3,707.2	5,184.7	39.9
Video and Audio Recorders and Players and Stereo Equipment	914.4	1,639.0	79.2
Television Sets	174.8	306.9	75.6
Radio Receivers	114.7	138.6	20.8
Tableware and Glassware	152.8	187.6	22.8
Metal Cookware and Cutlery	160.3	181.8	13.4
Photographic and Optical Goods	395.7	476.3	20.4
Clocks and Watches	161.7	182.7	13.0
Toys and Sporting Goods	131.6	198.0	50.5
Motorcycles and Parts	463.4	391.8	-15.5
Clothing	140.1	233.9	67.0
Intermediate Goods	2,513.0	3,532.1	40.6
Steel Mill Products	835.0	1,458.5	74.7
Nonferrous Metals	200.6	265.8	32.5
Organic Chemicals	220.7	251.5	14.0
Tires and Tubes	185.8	268.5	44.5
Textiles	254.3	337.3	32.6

Japan's role in this year's run-away U.S. trade deficit continues to defy conventional wisdom. The bilateral red-ink entry did shoot up to $15.5 billion in the first six months of 1984 from $9.1 billion in the year-earlier period and $10.2 billion in the last half of 1983 (see accompanying tables), but this jump represented only one-fifth of the deterioration in the overall trade deficit. Helped by an upturn in capital spending and higher prices for some key agricultural and industrial materials, sales to Japan again outperformed exports to other major markets in 1984's first half, increasing 15.4 percent to $11.6 billion. At the same time, however, imports of Japanese-made products, which were off slightly in the January-June 1983 period, went through the ceiling, zooming up 41.5 percent to $27 billion.

The bilateral trade deficit could easily top $30 billion this year. By how much is the big question. An end to stronger-than-anticipated U.S. growth in the last half of 1984 will do little to dampen business and consumer demand for Japanese-made products since the economy will still be increasing at a fast clip. Moreover, the run-up in the dollar's value is giving Japanese exporters an extra competitive edge in the expanding American market. In any case, the fourth quarter of the year is always the biggest import period. What could keep the trade deficit close to $30 billion is a continuation of the pickup in domestic demand in Japan, particularly in industries like steel and construction that buy big-ticket intermediate supplies.

Susan MacKnight

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The views expressed in this report are those of the authors and do not necessarily represent those of the Japan Economic Institute.

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